# In the Supreme Court of the United States

OCTOBER TERM, 1974

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No. 74-176

JOSEPH W. JOHNSON, JR., ET AL., PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners each borrowed funds without personal liability from a commercial bank and pledged as security shares of appreciated stock. Thereafter they transferred ownership of the pledged stock to trusts established by them, subject to the outstanding loans. They challenge the decision below which held that the difference between the loan proceeds and their basis in the transferred stock had to be recognized as gain for federal income tax purposes.

The transaction of petitioner Joseph W. Johnson, Jr. is typical of the three involved in this case. The pertinent facts, using approximate figures, were as follows: Petitioner owned stock having a cost basis of $10,000 and a fair market value of $500,000. He pledged that stock with a bank to secure a loan of $200,000.

Under the loan agreement, petitioner incurred no personal liability for repayment and the bank's recourse was limited to the pledged stock. Immediately thereafter, petitioner transferred the stock, subject to the bank's security interest, to an irrevocable trust created by him for the benefit of his children.[1] Petitioner incurred a gift tax liability of $150,000 by virtue of his transfer to the trust, and he paid this out of the $200,000 loan proceeds received by him (Pet. App. A47-A48).

On audit, the Commissioner of Internal Revenue determined that petitioner realized $200,000 as a result of this transaction and that the $190,000 excess over petitioner's $10,000 basis in the transferred stock constituted income taxable as long-term capital gain under Sections 61, 1001, and 1222 of the Internal Revenue Code of 1954. The Tax Court sustained the Commissioner's determination (Pet. App. A1-A43), and the court of appeals affirmed (Pet. App. A46-A59).

This Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1, required the conclusion that petitioners' transfer of property subject to a pre-existing lien resulted in a realization of income in the amount of the lien, even though there was no personal liability for the obligation secured by the lien.[2] Petitioners acknowledge (Pet. 9) the applicability of *Crane* to their transfers. They contend, however, that their tax-

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[1]The trustee of the trust executed and delivered to the bank the trust's own note for $200,000, and petitioner's note was deemed "paid" (Pet. App. A7).

[2]The *Crane* rule applies, at the very least, to the situation where, as here the value of the property exceeds the amount of the lien. See 331 U.S. at 14, n. 37.

able gain should be computed as though they had realized only $50,000 from the transaction because, as they assert, they had no economic gain from the application of $150,000 to discharge their gift tax liability. But this Court long ago rejected a similar argument in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729, which held that income is realized through the discharge of a tax liability as much as in any other form. As the court below remarked (Pet. App. A52), petitioners received $200,000 free and clear of any obligation to repay, and it made "no difference to what use the $200,000 was put, whether to pay for food or to pay a gift tax."

Contrary to petitioners' argument (Pet. 11-12), the decision below does not conflict with *Estate of Davis* v. *Commissioner*, 30 T.C.M. 1363, affirmed *per curiam*, 469 F.2d 694 (C.A. 5). In that case, the taxpayer made a gift of property subject to the condition that the donee would pay the resulting gift tax liability. The Commissioner argued that the donee's payment of the gift tax resulted in realization of income to the donor on the theory that the donor had received consideration for the transfer in the amount of the gift tax paid by the donee which was an "amount realized" under Section 1001(a). The Tax Court and the Fifth Circuit rejected the Commissioner's determination, holding only that the taxpayer had made a net gift, *i.e.*, the value of the property less the gift tax paid by the donee. A similar result was reached in *Turner* v. *Commissioner*, 49 T.C. 356, affirmed *per curiam*, 410 F. 2d 752 (C.A. 6). See also *Krause* v. *Commissioner*, 56 T.C. 1242.

The Tax Court noted (Pet. App. A34-A36), that the transfers in this case were not conditional on the

payment of the gift tax liabilities by the donees. Thus, there was no factual basis here for the conclusion in *Davis* and similar cases that petitioners had made net gifts of the appreciated stock. Moreover, unlike this case, *Davis* did not involve the transfer of property subject to a pre-existing lien which rendered the amount of the lien an "amount realized" under this Court's *Crane* decision. As the court of appeals correctly observed (Pet. App. A54), "[w]e believe that the transactions in this case fall within the parameters of *Crane*, especially in view of the fact that the taxpayers actually received cash without liability to repay the notes out of their own assets."

To be sure, the distinction between the payment of the gift tax by the donees in *Davis* and the use of the loan proceeds by petitioners to pay the gift tax should not warrant a difference in tax treatment. In both cases, the amount of the gift tax is an "amount realized" under Section 1001(a), although petitioners' actual receipt of cash with no personal liability to repay it graphically illustrates the point. Indeed, the court of appeals appears to have recognized the error of the net gift analysis of *Davis* and its *Turner* decision in its statement (Pet. App. A59) that "*Turner* has no precedential value beyond its peculiar fact situation." The decision below may therefore augur the explicit overruling of the net gift analysis of *Turner* by the Sixth Circuit and a conflict with *Davis* in a case in which the *Crane* doctrine is not applicable. However, there is no reason to resolve this eventual conflict by review of this case, the facts of which are unquestionably governed by *Crane*.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
*Solicitor General.*

OCTOBER 1974.